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RUEHKP/AMCONSUL KARACHI 2447
RUEHCG/AMCONSUL CHENNAI 9020
RUEHBI/AMCONSUL MUMBAI 6355
RUEHC/DEPT OF LABOR WASHDC
RUEATRS/DEPT OF TREASURY WASHDC
RUEHLMC/MILLENNIUM CHALLENGE CORPORATION

UNCLAS SECTION 01 OF 02 COLOMBO 000215

SENSITIVE

SIPDIS

STATE FOR SCA/INS AND EEB/IFD/OMA
STATE PASS USTR FOR ADINA ADLER AND VICKY KADER
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SUBJECT: SRI LANKA: MORE STIMULUS

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(b) 08 STATE 134459
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¶1. (U) SUMMARY: In addition to a Rs 16 billion (USD 140 million) stimulus package announced in December 2008 (ref a), the GSL recently announced several steps to provide support to its economy, introducing a Rs 4.2 billion (USD 36 million) stimulus package for finance and leasing companies, interest rate cuts, and export subsidies. While the interest rate cuts and the export "rebate scheme" are intended to directly address problems arising from the global economic crisis, the government hopes its actions to provide assistance to the leasing and finance sector will restore public confidence following major local scandals from unregulated finance companies. End summary.

RATE CUTS

¶2. (U) Hoping to help stimulate the economy, on February 11 the Central Bank (CB) reduced its key interest rates, lowering both the repurchase rate and reverse repurchase rate by 25 basis points to 10.25 percent and 11.75 percent, respectively. This is the CB's first interest rate cut in repurchase and reverse repurchase instruments since February 2007. (Note: Borrowing is restricted to three times per month. End note.) The Central Bank also cut its penal interest rate from 17.0 percent to 16.5 percent. This cut follows a 200 basis point rate cut in January. In its public statement, the CB said its reductions are expected to "pass through to other market interest rates soon and lead to significant reductions in the cost of borrowing, resulting in economic activity being stimulated in the face of adverse conditions brought on by the global economic slowdown." On February 24, hoping to further improve liquidity, the Central Bank announced a reduction in the statutory reserve ratio (SRR). The SRR will be reduced by 75 basis points to 7.0 percent starting on February 27. This move is expected to add Rs 9 billion (USD 78 million) to the banking system.

¶3. (U) Meanwhile, since January 1 Treasury bill rates have been reduced by about 150 basis points to 15.76% (3 month) and 17.73% (1 year). Nevertheless, prime lending rates, at which banks lend to key customers, continue to hover above 19%.

PRODUCTIVITY SCHEME TO MAINTAIN EXPORTS

14. (U) On February 19, the government announced a subsidy arrangement for all exporters, expanding the coverage of an earlier program that was restricted to apparel and leather products exporters (ref a). Under the scheme, companies able to maintain export earnings at 2008 levels will be given a government-funded 5% rebate in Sri Lankan rupees (SLR). Companies maintaining earnings between 90-99% will be given a 3% rebate in SRL. Exporters must also maintain 2008 employment numbers (no lay offs) and meet yet-to-be-determined value addition criteria for each industry. Companies' performance will be reviewed, and "rebates" given, on a quarterly basis. Rebates will be free of corporate tax. Businesses with a three-year track record of exports are eligible to participate.

SUPPORT FOR FINANCE AND LEASING COMPANIES

15. (U) Acknowledging waning public confidence in registered finance companies and leasing companies following local scandals involving unregulated companies, on February 20 the Central Bank announced a Rs 4.2 billion (USD 36 million) package for the sector. The package, which is to be implemented "soon," aims at addressing liquidity and funding problems in this sector, which accounts for around 9% of the overall financial sector in country. The package contains two key features. First, finance and leasing companies will be able to sell part of their land stock to a government bank (Rs 2 billion). The government-owned Lankaputra Bank will offer to

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purchase land from finance and leasing companies at a maximum of 67% of the land value. Payment will be in government bonds, which may then be discounted in the secondary market to raise cash. Second, the Central Bank will guarantee credit provided by commercial banks to finance and leasing companies (Rs 2.2 billion).

16. (U) At the same time, the CB also announced plans to reduce the liquidity requirement of finance companies. In return, the finance and leasing companies will be asked to reduce interest and lending rates by 2%. (Note: The Central Bank proposed that vehicles and equipment seized by these companies be returned to the original customers; however, it did not detail this as a requirement.) The Central Bank plans to strictly monitor companies receiving assistance under this package and to impose restrictions on incentive payments to top management. As is too often the case, there was no clear indication as to how the government will fund the package, although a CB press release said that it will consider the release of funds available in a medium and long term credit facility to support the package.

COMMENT

17. (U) The above financial sector assistance measures are likely to ease the local liquidity shortage. In particular, the finance and leasing sector package is viewed as a lifeline to the sector. According to finance industry sources, about 75 percent of the companies in the finance and leasing sector are facing difficulties and will take the Central Bank offer. This action will also help restore confidence in a sector badly damaged due to major scandals in unregulated finance houses.

18. (SBU) The effectiveness of the export subsidy scheme remains uncertain. Exporters report it will be difficult to maintain export incomes when both export volumes and prices are falling. As a result, few will likely be able to reap the benefits on offer. Some see the subsidy as an attempt to make up for the overvalued rupee. Although the SLR has depreciated by about 6 percent against the dollar in the last twelve months, it appreciated sharply against most other currencies, lowering the competitiveness of Sri Lanka's exports. (Note: According to a Central Bank index, Sri Lanka's real effective exchange rate has appreciated by 22 percent in the twelve months to November 2008.) Exporters face a tough year ahead

as many try to determine if and how they can maintain profitability
in the current economic downturn.